

INITIAL STATEMENT OF REASONS  
FOR THE ADOPTION/AMENDMENTS OF RULE CHANGES UNDER THE  
CALIFORNIA FINANCE LENDERS LAW AND THE  
CALIFORNIA RESIDENTIAL MORTGAGE LENDING ACT

As required by Section 11346.2 of the Government Code, the California Corporations Commissioner (Commissioner) sets forth below the reasons for the proposed adoption of Sections 1436 to Article 3 of Subchapter 6 and 1950.314.8 to Article 9 of Subchapter 11.5 of Title 10 of the California Code of Regulations (10 C.C.R. Sections 1436 and 1950.314.8).

**I. In General**

The Department of Corporations (“Department”) licenses and regulates finance lenders and brokers under the California Finance Lenders Law, and residential mortgage lenders and servicers under the California Residential Mortgage Lending Act. These laws require licensees to comply with certain requirements relating to books and records, examinations, and reporting. See Financial Code Sections 22156, 22157, 22159, 22701, 50124, 50302, 50307, and 50314. Moreover, these laws prohibit licensees from engaging in certain unlawful practices such as unconscionable contracts, loans that do not take into consideration the borrowers’ ability to repay, fraudulent underwriting practices, unsafe and injurious practices, and false advertising, as specified. Licensees must also provide clear statements concerning loans, as specified. See, as examples, Financial Code Sections 22161, 22163, 22164, 22302, 22714, 50204, 50308, and 50322.

On November 14, 2006, the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) distributed Guidance (the “Guidance”) to state agencies that regulate mortgage lenders. The Guidance is available on the AARMR website at [www.aarmr.org](http://www.aarmr.org). The Guidance addresses risks posed by nontraditional mortgage products such as interest-only loans. In addition, the Guidance includes directives for lenders involved in mortgage programs directed at subprime borrowers. As stated by CSBS and AARMR in their joint press release, also available on this website, the Guidance serves to inform and protect consumers and enhance the safety and soundness of the industry. Accordingly, CSBS and AARMR encouraged state regulatory agencies to adopt the guidance and to issue it for use by regulated entities.

In general, this proposed rulemaking is necessary to carry out the Guidance. The proposed rulemaking requires licensees operating under the California Finance Lenders Law and the California Residential Mortgage Lending Act to: (1) implement appropriate and best risk-management practices on a continuous basis including, but not limited to, the Guidance; (2) report annually to the Department, in relation to the Guidance, on whether they have made or arranged nontraditional mortgage products, whether they have implemented risk-management best practices, whether they have put into place internal controls or procedures, as specified, and to also report annually on the number of any consumer complaints; and (3) maintain specified documentation

as part of their books and records, and make the documentation available to the Commissioner upon request; (4) require clear disclosures for nontraditional loans; and (5) prohibit certain false, misleading, and deceptive advertising.

## **II. The Guidance**

The Guidance sets forth various directives for mortgage lenders and brokers offering nontraditional mortgage loan products, which are designed to influence loan terms and underwriting standards, risk management practices, consumer protection issues, and operating practices. As explained by CSBS and AARMR, the Guidance is needed for several reasons. First, the Guidance assists state regulators of mortgage companies to promote consistent regulation in the mortgage market. Additionally, the Guidance clarifies how mortgage lenders can offer nontraditional mortgage products in a way that clearly discloses the risks that borrowers may assume. (See Section I, “Introduction,” discussion of the Guidance.) Moreover, the Guidance is needed to address risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and/or interest, given that borrowers may not fully understand the risks of these nontraditional loan products. (See Section II, “Background,” discussion of the Guidance.)

Consistent with the stated objectives of the Guidance, Sections 1436 and 1950.314.8 of this proposed rulemaking set forth requirements for appropriate and best risk-management practices that are needed to ensure that mortgage loan providers will effectively assess and manage risks associated with nontraditional loan products. Moreover, the proposed rulemaking also sets forth reporting and books and records requirements that are necessary to enable the Department to carefully review the risk-management practices, policies and procedures in this area. This proposal also requires certain disclosures and prohibits false advertising, as specified, in connection with nontraditional mortgage loans.

## **III. Recent Hearings and Findings**

On January 31, 2007, the Senate Banking, Finance and Insurance Committee held an informational hearing on nontraditional mortgage products and published a report entitled, “Sustainability, Not Attainability – An Examination of Nontraditional Residential Mortgage Lending Products and Practices.” In the “Key Findings” discussion of the staff summary report, the following consensus items, as summarized, also support the need for this proposed rulemaking: home ownership should be sustainable; borrowers may not understand the terms of nontraditional loan products; loans may be mismatched for certain borrower profiles; the state should apply the Guidance to state regulated lenders and brokers in a uniform fashion; borrowers should receive meaningful disclosures concerning nontraditional loan products; and the need for more mechanisms to help protect borrowers from unscrupulous mortgage professionals. The committee report also includes a background paper that makes certain findings concerning recent trends in the California mortgage market such as the increase of nontraditional mortgage loan products, the financial risks assumed by mortgage providers, and the rising level of delinquencies. On March 26, 2007, the Senate Banking, Finance and Insurance Committee held a follow-up informational

hearing entitled “Reactions to the Recent Subprime Mortgage Collapse.” The Committee’s background paper includes additional information about recent problems experienced in the subprime market. The background paper also describes the proposed “Statement on Subprime Mortgage Lending” dated March 2, 2007, proposing additional guidance to help address subprime loan problems including certain adjustable rate mortgages.

Sections 1436 and 1950.314.8 of this proposed rulemaking are needed to clarify and make specific the manner in which licensees will be required to follow the Guidance thereby helping to help address the findings of the recent committee hearing and the report and background paper prepared in connection with those hearings. Accordingly, pursuant to Government Code Section 11346.2(a)(2), the Department is relying upon and hereby identifies the committee report and the background paper, as described above, in proposing this rulemaking.

#### **IV. Sections 1436 and 1950.314.8**

The Department licenses and regulates mortgage loans under both the California Finance Lenders Law and the California Residential Mortgage Lending Act. Under the Guidance, mortgage providers that do not adequately manage risks associated with nontraditional loan products will be asked to take remedial action. Accordingly, this proposed rulemaking is needed to clarify the obligations of licensees (e.g., best practices, reports, and books and records), thereby specifying the circumstances under which a violation of a rule may give rise to Department enforcement activity. It is also noteworthy that current law sets forth various limitations and prohibitions on lending activities. For example, current law prohibits finance lenders from failing to take into consideration the borrowers ability to repay, as specified, and prohibits them from making unconscionable loans. See Financial Code Sections 22302, 22714. Moreover, existing law prohibits licensees from engaging in fraudulent underwriting practices, and unsafe and injurious practices, as specified. See Financial Code Sections 50204 and 50322. Given the existing enforcement mechanisms in place to help guard against the risks associated with loans, including nontraditional mortgage products, the proposed rulemaking may also enable the Department to detect patterns and practices of other violations of law.

Sections 1436 and 1950.314.8, subsection (a), require licensees to implement appropriate and best risk-management practices, as specified. Deference will be given to the licensees to implement and apply practices that meet their operational needs. Thus, the rulemaking is needed to provide flexibility to licensees to help carry out the stated objectives of the Guidance. Additionally, the rules require licensees to implement these practices on a continuous basis. This provision of the rule is needed to ensure that licensees understand that mere adoption of risk-management practices, as specified, is not enough. Licensees also have an obligation to ensure that these practices are implemented on a continuous basis with respect to their nontraditional mortgage products. Likewise, the rule clarifies the obligation of the Department to check for continued implementation of the Guidance. It is noteworthy that the specified risk-management practices are not limited to the Guidance or any subsequent amendments to the Guidance. This provision provides additional flexibility to licensees

to adapt to changed circumstances and other standards that may be adopted in the future including any amendments to the Guidance.

In addition, Sections 1436 and 1950.314.8, subsection (b), specify reporting requirements that are needed to enable the Department to scrutinize the adoption and implementation of risk-management practices required by subsection (a) of the proposed rule. To help clarify and make specific the timing of the special report, subsection (b) requires licenses to submit it as part of the annual report, pursuant to Financial Code Sections 22159 and 50307. This provision will help eliminate the need for submitting two separate reports at different times each year. The rule also requires a separate written report as an addendum to the annual report, to help specify the format of the report required by the rule. In addition, licensees must state whether they have made or arranged nontraditional mortgage products as defined by the Guidance, explain how they have implemented risk-management practices, explain whether and how they have put into effect specified internal controls and procedures, and indicate whether they have received consumer complaints regarding loans that are subject to the Guidance, including resolved and unresolved complaints, as specified. These provisions are needed to help licensees understand their reporting obligations. More importantly, this information will help the Department understand the scope of continuous implementation by each licensee. The Department can also use these reports to assess the level of compliance with the Guidance among the licensees. Therefore, the Department can prioritize examinations, including examinations conducted under Financial Code Sections 22701 and 50302, to review implementation of the appropriate and best risk-management practices, as required by the rule, including any internal controls and procedures.

Under subsection (b), licensees that make or arrange nontraditional mortgage loans, as specified, must also provide information concerning their products in a form prescribed by the Department. The form (entitled Nontraditional Mortgage Loan Survey and dated 5/1/07) is available on the Department's website at [www.corp.ca.gov](http://www.corp.ca.gov). This information is needed because, as described above, nontraditional mortgage loans pose higher risks than do traditional amortizing mortgage loans. In addition, nontraditional mortgage lending activity has drawn increased scrutiny from a wide range of sources, with concerns being expressed regarding the possibility that some borrowers are being exposed to undue levels of risk given their financial and repayment capacity, possibly without their full understanding of the terms and features of the mortgage loan products they are obtaining. It is in the interests of the Department, its licensees, and the borrowers to ensure that the needs of mortgage customers are met in a manner that is safe and sound for the licensees, yet does not expose the borrowers to an undue level of risk that they may not fully understand. In order to be able to develop appropriate guidance for its licensees and its examination staff, the Department already conducted a survey to obtain this additional information regarding the extent and nature of the nontraditional mortgage loan products being offered by its licensees. Accordingly, this rule formally adopts the information requirement and form on an ongoing and annual basis.

Sections 1436 and 1950.314.8, subsection (c), require licensees to maintain documentation including copies of complaints and responses or explanations of how

the complaints were resolved, the documentation of internal controls and procedures, and any loan documentation required by law, as specified. These provisions are needed to clarify and make specific the types of books and records that must be maintained by licensees under various books and records requirements including Financial Code Sections 22156, 22157, 50124 and 50314. Moreover, the rule enables the Department to have access, upon request, to documentation for the purpose of examining compliance by licensees.

Subsection (d) requires licensees to cause to deliver, as specified, certain disclosures to borrowers concerning payment scenarios and loan balance scenarios, among various nontraditional loan products, as prescribed by the Department. The Department form (entitled Comparison of Sample Mortgage Features: Typical Mortgage Transaction and dated 5/1/07) is available on the Department's website at [www.corp.ca.gov](http://www.corp.ca.gov). This form of disclosure is needed to help borrowers understand the payment obligations and loan balance obligations of various nontraditional loan products, and to help them make an informed product choice. By requiring the information within three days of loan application or obligation on the note, whichever is earlier, the rules ensure that information is provided to borrowers at the earliest possible time, and to help them avoid misunderstandings before they commit themselves to the loans or pay loan documentation fees. The rule and form of disclosures also help carry out existing laws which require clear statements concerning charges and other costs of loans, and help ensure that material information is provided in a conspicuous manner. The sample form is based on information proposed by the Department of Real Estate in its Form RE 885, to provide greater uniformity of disclosures in connection with nontraditional loan products. This table format helps provide a one-page and user-friendly comparison chart with helpful examples, so borrowers can compare payment and loan balance obligations of various loan products. By requiring "at a minimum" the content of the form prescribed by the Department, the rule provides flexibility to include other illustrations and scenarios.

Finally, subsection (e) prohibits certain advertising that is deemed false, misleading, and deceptive. This subsection is needed to help curb misrepresentations in connection with nontraditional mortgage products and to help carry out the consumer protection goals of the Guidance. The provisions also clarify and make specific the types of representations that constitute prohibited advertising, so licensees can understand and guard against them as they implement the Guidance on an ongoing basis. In addition, the proposed rule also achieves greater uniformity among mortgage loan providers, since the Department of Real Estate is proposing the same advertising prohibitions in its rules as well.

#### ECONOMIC IMPACT GOVERNMENT CODE SECTION 11346.2(b)(4)

The Commissioner has made a determination that the proposed rulemaking will not have a significant adverse economic impact on business because this proposal helps eliminate risk of loss associated with nontraditional loan products.

#### FISCAL IMPACT

Cost to Department of Corporations: \$125,000 per year. No cost or saving to

any other state agency.

Cost to local agencies and school districts required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of the Government Code: None.

No other nondiscriminatory cost or savings are imposed on local agencies.

#### TECHNICAL STUDIES RELIED UPON

In proposing this rulemaking, the Department is relying upon the February 2007 report of The California Senate Banking, Finance and Insurance Committee entitled "Sustainability, Not Attainability - An Examination of Nontraditional Residential Mortgage Lending Products and Practices," together with information contained in that report, including the Guidance. In addition, the Department is relying on the background paper of the Senate Banking, Finance and Insurance Committee prepared for its March 26, 2007 hearing entitled "Reactions to the Recent Subprime Mortgage Collapse."

#### ALTERNATIVES CONSIDERED

No reasonable alternative considered by the Department or that have otherwise been identified and brought to the attention of the Department would be more effective in carrying out the purpose for which the regulation is proposed, or would be as effective and less burdensome to affected private persons, or would lessen any adverse impact on small business.